

Dir. Resp.: Thorold Barker

A New, Old Path to Fiscal Union for Europe

Leaders can use an existing fund as the basis for the risk-sharing the eurozone needs in order to survive.

By **Marcello Minenna**

Eurozone reform is back on the agenda. French President Emmanuel Macron has made greater integration—especially on fiscal matters—a cornerstone of his agenda. And German Chancellor Angela Merkel may be in a position to take more steps in that direction now that she has won re-election. But what can or should they do to strengthen the currency bloc?

Some European leaders talk about a much closer fiscal union. The creation of a European Union finance minister with power to distribute taxpayer money could serve as a buffer in recessions. Such a mechanism, the thinking goes, would reduce the risk that a sovereign default in one euro country would trigger a financial crisis somewhere else.

This new model isn't politically feasible right now. But the EU already possesses an institution that, if reformed appropriately, could bolster the eurozone's ability to prevent sovereign crises.

The European Stability Mechanism, or ESM, was established in 2012 to provide financial assistance to distressed countries, and became the primary conduit for EU financing during bailouts in Cyprus and Greece. Its only other outing to date has been a rescue of some Spanish banks, and its total disbursements so far have been less than €100 billion (\$118.86 billion).

The ESM represents the outline of a form of fiscal cooperation on which the eurozone could agree. It has a maximum lending volume of €500 billion and subscribed capital of €704 billion, of which €80.5 billion is already paid in; the remainder is callable shares.

The ESM is also able to issue supranational bonds, eligible for purchase under the European Central Bank's asset-purchase program, or quantitative easing. Its low leverage

and explicit government backing guarantees a low funding cost.

But the fund is currently too small to rescue a government such as Italy—the eurozone's third-largest and highly indebted economy, which the German Council of Economic Experts in 2016 called "too big to save."

The ESM's existing decision-making process is also too inefficient for these purposes. Most of the fund's important decisions must be made unanimously or, in case of emergency, with the approval of 85% of the votes cast. Germany, the largest shareholder with a 26.9% stake, holds a veto.

These limitations can be remedied by making the ESM an automatic guarantor of all sovereign debt in the eurozone and requiring governments to pay their fair share for this protection.

Governments would start by including risk-sharing clauses in new bond issues, under which the ESM would guarantee that maturing bonds in the new issue would benefit from the joint liability of all ESM member countries. Within eight to 10 years, all government bond issues would include such clauses.

In exchange for this guarantee, countries would be required to compensate the ESM by making cash contributions to ESM capital. The formula for these contributions would take into account the net balance of the protection sold by a country to other participants in the fund and received from others.

Stable governments such as Germany would pay little or no additional contribution relative to today since they would bear a disproportionate share of the risks. Conversely, more-indebted and riskier governments, such as Italy, would pay more than others.

In effect, the ESM would be selling to its members a credit-default swap on whatever sovereign risk exceeds the weighted average of all

sovereign risk in eurozone bonds. To preserve the ESM's investment-grade rating, the maximum expected loss cannot exceed paid-in capital. So ESM guarantees would expand to cover all sovereign debt only gradually as members fulfilled their contribution duties.

The introduction of risk-sharing clauses would restore markets' confidence in the resilience of the eurozone and fuel the convergence of sovereign yield curves, reducing the overall riskiness of eurozone public debt and aligning the default probabilities for all eurozone members.

Meanwhile, ESM reform should be combined with a revision to existing fiscal compact rules that excludes fruitful public-works investments from deficit limits. The amount of allowable public-works spending would be equal to the amount of capital each member country paid each year for its bond guarantees from the ESM. The ESM would then be able to help finance that public-works spending by offering guarantees for the bond issues to pay for it.

An ESM 2.0 based on risk-sharing and convergence of sovereign yield curves and the reboot of public fruitful investments with a higher degree of flexibility than today could be the skeleton of a future federal budget that can rely on the possibility of issuing supranational bonds of the eurozone. Importantly, it would be more flexible than the German proposal to transform the ESM into a monetary fund while inserting clauses into new bond issues making default or redenomination into a potential local

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currency harder.

Europe needs to find a way to make its unique monetary experiment—the euro—work better. The important question will be whether Europeans are prepared to move toward an eventual break-up of the euro, which would be driven by stringent limits on credit issuance, or whether they want to create institutions such as a new ESM that can finally allow the euro to work.

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